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Resolving Texas Thrift Problems

Statement of
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Comptroller General
of the United States

Before the
Committee on Banking, Finance
and Urban Affairs
House of Representatives

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to assist the Committee in its continuing efforts to forge an approach to solve the crisis we have with our nation's thrift industry.

As we said in our February 21, 1989, report to this committee detailing our solutions to the thrift industry problem, Congress needs to quickly adopt a comprehensive plan to pay Federal Savings and Loan Insurance Corporation's (FSLIC's) bills and minimize the chance that the FSLIC situation is repeated.[1]

As you know, for several months we have discussed our proposals with this Committee as well as with officials of the Bush Administration. The administration has acted quickly to take control of insolvent thrifts and has involved the Federal Deposit Insurance Corporation (FDIC), as we have recommended. And its proposal incorporates many of the fundamental structural and regulatory reforms we believe must be made to help assure that this problem does not occur again.

The Congress should give prompt consideration to this proposal. We are, however, still analyzing the proposed legislation, and we have concerns about some aspects of the bill. Mr. Wolf, our Assistant Comptroller General for Accounting and Financial

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[1]Troubled Financial Institutions: Solutions to the Thrift Industry Problem, GAO/GGD-89-47, February 21, 1989.)

Management discussed some of these yesterday. I want to highlight several that I believe are most important.

-- The administration's plan does not provide adequate independence for the FDIC Chairman because he serves as Chairman at the pleasure of the President. Decisions regarding actions that need to be made by the insurance agencies to protect the integrity of their funds and the safety and soundness of the people's deposits should be made without undue political pressure. A fixed term of office for the Chairman to serve in that capacity would help provide the necessary political insulation.

-- Thrift supervisors and examiners would still be under the control of the Federal Home Loan Bank System. While giving FDIC limited examination authority and having the Bank System under the Treasury may alleviate some of the conflicts of interest, we do not believe this is sufficient. Thrift supervision should reside with the new independent deposit insurance fund.

-- Most of the money to pay for the FSLIC rescue will come from the Treasury and from the sale of $50 billion in bonds by an off-budget financing entity. The administration estimates that about $77 billion in Treasury appropriations will be

needed through 1999 to help pay for past actions, new cases, a new reserve, and interest.

No one can say at this point how much will ultimately be needed, but our work suggests that this financing plan, together with the oversight board that would be created, provides a reasonable framework for proceeding to solve the thrift industry problem. However, because the plan rests on several optimistic assumptions regarding such factors as interest rates and the outlook for the economy, the costs are likely to be higher than those currently envisioned in the plan. We also believe all aspects of the plan should be fully reflected in the budget.

-- To assure congressional oversight, we believe it is essential that GAO have comprehensive authority to audit all organizations and activities provided for in the administration's proposal. We have drafted an amendment to the administration's bill that would provide this authority and will submit it to the Committee.

1988 FSLIC ACTIONS IN TEXAS

We are pleased that the administration has stopped the type of assisted transactions entered into by FSLIC in 1988.

Today, we are releasing our report to you on the Bank Board's resolutions of Texas Thrifts (GAO/GGD-89-59). While the concept of developing a regional plan to deal with insolvencies was a good one, we have serious reservations about the design and implementation of the plan.

In recent years, the federal government has been involved in several financial rescues. In 1984 we issued a report, based on the government's experience with the Chrysler Corporation, New York City, and several other situations about how such efforts should be structured. The guidelines in that report underscore the importance of developing an adequate plan to finance, implement, and oversee these types of situations.

The Bank Board's actions have not been consistent with these guidelines.

At the start of 1988, 125 of the 279 thrifts in Texas were GAAP insolvent. Without first implementing reforms and securing adequate funding and staff resources, FHLBB acted on insolvencies principally by executing merger agreements that last up to 10 years. During 1988, FSLIC merged 87 insolvent Texas thrifts in 15 assistance packages. FSLIC reported the cost of these actions at about $24.5 billion in present value terms, or about $44 billion on a cash basis.

CONCERNS ABOUT THE TEXAS ASSISTED TRANSACTIONS

There is still a thrift industry in Texas but we are concerned about the viability of the new thrifts. Also, the ultimate cost to the government of the 1988 transactions is uncertain. With little cash to liquidate insolvent thrifts, and without accurate information on the real financial condition of the thrifts, the Board provided a wide range of financial assistance in the form of notes and guarantees to attract acquirers to buy packages of thrifts.

The cost of this assistance could be more than FSLIC has estimated if (1) the assets for which FSLIC provides an operating subsidy have lesser value than unaudited financial reports indicate, requiring increases in FSLIC subsidies, or (2) interest rates increase, making it difficult for thrifts to realize projected income levels and increasing the amount of FSLIC assistance needed.

The process used to solicit and select purchasers for the Texas thrifts was administered inconsistently by the Bank Board and the Dallas District Bank. The Bank Board decided to use a "blind bidding" process so in most cases the investors did not know the thrifts they were bidding on.

No Texas thrifts were liquidated under the plan. Acquirers who purchased the packages of failed thrifts were given 10-year notes, asset value guarantees, yield coverage, reimbursement for certain expenses, extensive tax benefits, and forbearance from certain regulations. These are summarized in Chart I.

We have concerns about these assisted transactions which are summarized in Chart II.

-- Ownership capital contributed by private investors has been minimal, and large, thinly capitalized institutions are being created. If history is prologue, inadequate capital creates incentives for highly leveraged institutions to engage in unsafe and unsound management practices. These new institutions may, therefore, pose risks to FSLIC in the future. In Texas, for example, FSLIC's own estimates, which are based on unaudited financial data, project that capital ratios of the merged thrifts will range from 1.3 to 5 percent in the first year with a median of 2.3 percent. After 5 years, the median capital ratio is projected to be 4 percent. By comparison, the largest 91 solvent U.S. thrifts, which are relatively comparable in size, currently have median capital ratios of 4.5 percent.

The above comparison of projected capital levels ignores the fact that capital requirements for most non-assisted thrifts are expected to increase significantly over the next 5 years. The thrifts in these transactions, however, are to a large extent, sheltered from these increasing requirements by capital forbearance on covered assets. Furthermore, the assets on which capital levels are based result substantially from the assistance agreements themselves, rather than from the acquirer's contribution. Capital, or the owner's stake, serves as an incentive to prudent management. With the limited capital in these institutions it is unclear whether adequate and proper incentives exist.

-- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC and are competing with nonassisted depository institutions at a cost advantage.

-- FSLIC provides capital loss coverage and an operating subsidy on assets that could make it profitable to simply hold them. We question the strength of the new institutions' incentives to actively manage and generate recoveries on those assets.

-- It is questionable whether many of these assisted transactions, especially when the tax consequences are taken into consideration, save the government money

compared to other options that would be possible if FSLIC would have had adequate funds and staff resources.

-- Finally, FSLIC faces a huge task in effectively administering these complex agreements.

Tax Considerations

Special provisions in the Internal Revenue Code grant substantial tax benefits to acquirers of insolvent thrifts. One provision makes the sale of insolvent thrifts eligible for tax-free treatment as a reorganization without meeting all of the usual requirements. Qualification as a tax-free reorganization and other special provisions allow the acquired thrift's pre-agreement net operating losses (NOLs) to be deducted against the future income of the new thrift.

The rules also enable the new thrift to carry over the full value of assets from the acquired thrift. Because this value is generally higher than the fair market value, there is a loss when the assets are sold. This "built-in" loss is deductible against the new thrift's income and also may be used to offset income of holding companies which own new thrifts.

Other special provisions provide that FSLIC assistance is excluded from taxable income and is not reflected in the tax

basis of the new thrift's assets. The primary FSLIC payments are: guaranteed rate of return on assets, interest on FSLIC note(s), and reimbursements for expenses and built-in losses. Chart III outlines both the deductions and exclusions. The use of these benefits was recently extended, but reduced by 50 percent, through December 31, 1989.

FSLIC provided us with projections of the tax consequences of the 1988 deals on February 9, 1989. They show tax consequences of $8.7 billion on a cash basis (as opposed to a present value basis.) We are in the process of analyzing the data and the assumptions used to compute the information.

I want to emphasize that determining accurately the tax consequences of these transactions is very difficult. The true market value of failed thrifts' assets, which affects the tax, is not known, nor is the timing of asset sales. The future profitability of the new thrift and any holding company are difficult to estimate. And, it is difficult to anticipate the future business decisions of the new owners in light of the tax benefits available.

The need for the continuation of the special tax provisions, which now apply to banks as well as thrifts, depends on the extent to which FSLIC and FDIC are able to resolve failed institutions using insurance funds only. In this regard, we

believe it would be far preferable to take the actions we have discussed to ensure the financial soundness of the insurance funds so that the insurers have the means to pay for, and thus fully recognize, resolution costs, rather than resorting to using special tax benefits.

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This concludes my prepared statement. My colleagues and I will be pleased to answer questions.

CHART 1

GAO

Typical December 1988 Deal

- Note for negative net worth
- Guaranteed return on assets
- Guaranteed book value of assets
- Reimbursed certain expenses
- Waived regulation compliance
- Tax benefits
- Equity position in S&L

CHART II

GAO Concerns About Deals

Creates new thrifts that are:

- Thinly capitalized
- Have cost advantage over healthy S&L's
- Lack incentives to manage assets

May cost more than liquidation

Will require huge monitoring job because of complexity

CHART 1111

GAO

Tax Benefits

- Deductions
  - Losses on asset sales
  - Pre-agreement NOLs
- Exclusions
  - Interest on FSLIC notes
  - Guaranteed rate of return on assets
  - Payments for losses on asset sales
  - Payments for certain expenses